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# **Israel's Economic Recovery: Hostage to Further Reform**

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**An Intelligence Assessment**

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December 1987*

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# **Israel's Economic Recovery: Hostage to Further Reform**

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**An Intelligence Assessment**

This paper was prepared by [ ] Office of  
Near Eastern and South Asian Analysis, with a  
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queries are welcome and may be directed to the Chief,  
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**Israel's Economic Recovery:  
Hostage to Further Reform**

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**Key Judgments***Information available  
as of 2 November 1987  
was used in this report.*

The next two to three years will test the Israeli Government's resolve to build on the gains it has made under the Economic Stabilization Plan adopted in July 1985. Failure to maintain economic austerity and move ahead with structural reform will confine the Israeli economy to mediocre performances. [ ]

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The Israeli economy's performance in 1987 and 1988 will probably be relatively strong—except for a deteriorating current account balance—although developments on several fronts could cause problems. The budget deficit—under control in 1985 and 1986—would swell if bailouts for troubled economic enterprises such as the kibbutzim and moshavim—collective and cooperative settlements—are adopted. [ ]

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Ministry of Finance officials fear that the government's bank share redemption totaling \$3.7 billion scheduled for October 1988 could trigger a personal spending binge that will destabilize the economy and rekindle an inflationary spiral. The government is committed to the redemption—which follows on the heels of a smaller payment in October 1987 totaling \$1.2 billion—as a result of the collapse of the Israeli stock market in October 1983. [ ]

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The approach of a national election in November 1988 will tempt Prime Minister Shamir to resort to expansionary fiscal or monetary policies to pump up the economy. Engaging in pump-priming economics, however, would scuttle serious reform efforts, greatly damaging the economy's long-term growth prospects. [ ]

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To lay the foundation for long-term economic growth into the 1990s, the government will need to implement structural economic reforms, particularly of the tax system and the capital market. A broad overhaul of Israel's tax system is not imminent, but the Ministry of Finance probably will implement some rate reductions and tax base changes beginning in 1989. The government is also likely to settle for piecemeal reforms of the capital market, such as easing the requirement that private pension funds purchase government bonds and allowing the private sector to raise more money in the capital market. [ ]

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Israeli leaders will face major policy dilemmas that almost certainly will delay and complicate their reform efforts. Most important, to achieve long-term growth the government probably will have to accept higher unemployment and further erosion in living standards. [ ]

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The government's sensitivities on these issues will serve to reinforce its dependence on US economic assistance. Any significant cutback in US economic aid would result in a major increase in Israel's current account deficit. For example, using our econometric model of the Israeli economy, we project that, if US economic aid were drastically reduced from the current annual level of \$1.2 billion to \$800 million in 1988 and to \$400 million in 1989, Israel's current account deficit would swell to \$1.1 billion in 1988 and to \$1.7 billion the following year. Increasing US economic assistance by granting supplemental aid of \$750 million to nearly \$2 billion in 1988 and 1989, on the other hand, would lead to a current account surplus of \$89 million in 1988 and hold the deficit to \$149 million in 1989.

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Given the importance of US aid, Israeli officials will expect Washington to increase assistance levels and will probably press for additional funds for balance-of-payments support. Israeli officials also may step up their lobbying for lower interest rates to reduce debt payments to the United States or may ask for the rescheduling or outright forgiveness of the approximately \$10 billion owed to the United States.

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Israel's Economic Recovery:  
Hostage to Further Reform

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The July 1985 Economic Stabilization Program

The National Unity government's adoption of the Economic Stabilization Program in July 1985 marked the first time that the government, private sector, and labor had agreed on a long-term strategy to address Israel's economic woes. Each party agreed to make sacrifices: the government to reduce its large annual budget deficit, the Histadrut labor federation to accept real wage erosion, and the private sector to tolerate higher interest rates.

The accord was forced by the severe economic crisis facing the country. By July 1985 foreign exchange reserves had declined to about \$2.4 billion—the equivalent of just over three months of imports—and the current account deficit was already about \$700 million for the year, according to the International Monetary Fund (IMF) and the Bank of Israel. Government expenditures continued to exceed revenues by a wide margin, leading to a budget deficit-GNP ratio of about 17 percent—the highest since the beginning of serious inflation following the 1973 Arab-Israeli war and the dramatic increase in world oil prices. High government spending, when combined with an expansionary monetary policy under which money supply growth averaged 310 percent annually from late 1983 to mid-1985, contributed to record inflation. As a result, consumer prices rose by over 440 percent in 1984.

To reverse this bleak situation, the Economic Stabilization Program sought to eliminate the most serious economic and social distortion—inflation—and to improve Israel's balance of payments. According to US Embassy reporting, Israeli economists believed that only by tackling inflation and the balance of payments simultaneously would the government pave the way for renewed economic growth and make possible structural change in the economy.

According to Bank of Israel Governor Michael Bruno, the central goal of the Economic Stabilization Program was to reduce the government's budget deficit

Table 1  
Israel: Prestabilization  
Economic Data, 1960-85<sup>a</sup>

| Period<br>(Year: Qtr) | Inflation | GNP<br>Growth | Budget<br>Deficit/<br>GNP | Money<br>Supply<br>Growth <sup>b</sup> |
|-----------------------|-----------|---------------|---------------------------|--|
| 1960:1-1973:3         | 7.6       | 8.5           | 2.7                       | 17.5                                   |
| 1973:3-1977:2         | 36        | 2.6           | 17.6                      | 26.5                                   |
| 1977:2-1979:4         | 71        | 3.0           | 17.2                      | 37.0                                   |
| 1979:4-1983:3         | 123.3     | 1.6           | 14.1                      | 97.1                                   |
| 1983:3-1985:2         | 398.6     | 5.3           | 17.0                      | 310.4                                  |

<sup>a</sup> All growth rates are at an annual percentage rate.  
<sup>b</sup> M1 is the basic measure of the Israeli money supply.

by \$1.5 billion, about 7.5 percent of Israel's gross domestic product. Other key aspects of the program included:

- Devaluing the shekel by about 19 percent.<sup>1</sup>
- Suspending wage contracts—including indexation—after granting a general wage increase of 14 percent.
- Freezing prices as a means to hold the line on inflation.
- Abolishing dollar-linked short-term deposits.
- Reducing the value-added tax, the excise tax on fuel, and required import deposits.
- Conducting monetary policy to stabilize the shekel's exchange rate.

Impressive Results

The progress achieved under the Economic Stabilization Program has been impressive. The cutting of subsidies and the 19-percent shekel devaluation raised the price level by 27.5 percent—or more than 1,700

<sup>1</sup> This devaluation, coupled with the sizable real devaluation in October 1983, led to a readjustment of the previously overvalued shekel.

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Figure 1  
Israel: Monthly Inflation Rates, 1984-87



<sup>a</sup> Percentage changes from previous month's price index (CPI) with the following percentage weights in the CPI by main groups—household maintenance, 9.56; housing, 23.0; health, 4.28; education, culture, and entertainment, 9.74; transportation and

communications, 15.1; furniture and household equipment, 6.48; clothing and footwear, 4.21; food (excluding fruits and vegetables), 18.6; other items, 9.03.

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percent at an annual average rate—in the first month of the program, for the highest monthly rate ever recorded in Israel. The inflation rate, however, came down to a 1- to 2-percent monthly rate within three months and has, on average, remained there. Other gains include:

- Slowing the growth in real government consumption from 3.8 percent in 1985 to 1.4 percent in 1986 and trimming the budget deficit.
- Halting the rapid growth in real private consumption expenditures by temporarily eroding real wage levels in late 1985.
- Reducing the unemployment rate to 5.7 percent in the first three months of 1987 as opposed to the 2-percentage-point surge in unemployment to 7.6 percent in the first three months of the Economic Stabilization Program.

Favorable external developments supported the domestic efforts, particularly:

- The granting of \$1.5 billion in supplemental economic assistance by the United States.
- The drop in the price of imported oil from an average of \$27 per barrel in July 1985 to about \$8 by August 1986, according to Israeli Government statistics.
- The depreciation of the US dollar.

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As a result, Israel achieved a current account surplus of over \$1 billion in 1985 and 1986 as opposed to chronic deficits exceeding \$1 billion in past years. It also built foreign exchange reserves to about \$5.1 billion by July 1987, according to the IMF.

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**Table 2**  
**Israel: Poststabilization**  
**Economic Data, 1985-86**

| Period<br>(Year:Qtr) | Inflation | Budget<br>Deficit/<br>GNP | Unem-<br>ploy-<br>ment | Real<br>Wage<br>Index |
|----------------------|-----------|---------------------------|------------------------|-----------------------|
| 1985:1-1985:2        | 11.9      | 12.5                      | 6.3                    | 125.4                 |
| 1985:3               | 10.9      | 5                         | 7.5                    | 96.9                  |
| 1985:4               | 2.1       | 4                         | 6.7                    | 106.9                 |
| 1986:1               | 0.6       | 3                         | 7.2                    | 122.5                 |
| 1986:2               | 2.2       | 2                         | 7.9                    | 136.9                 |
| 1986:3               | 1.0       | 4                         | 6.8                    | 124.6                 |

Note: Inflation is expressed as percentage change for last month of period relative to last month of previous period at a monthly rate. Budget deficit to GNP is expressed as a percentage ratio. Unemployment is the unemployment rate. Real wages are reported in an index with December 1980 set equal to 100.

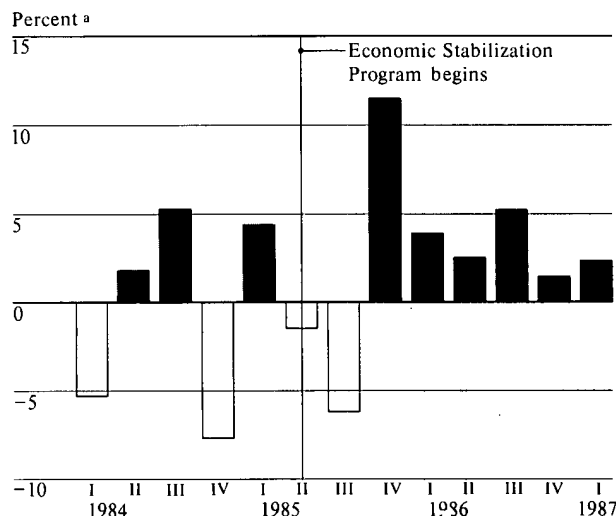
### Outlook Through 1988

Developments during the first nine months of 1987 point to cracks in the Economic Stabilization Program. In our judgment, Israeli leaders have lost the political will to press for additional large spending reductions, a key factor in preventing major new inflation. They probably will settle for future budget deficits in the range of 4 to 5 percent of GNP—as opposed to eliminating the deficit—to avoid antagonizing special interest groups and squabbling among government ministries.

In our view, the government also will yield to labor demands for wage increases to offset real wage erosion in exchange for either a longer term wage agreement—probably two years—or for reductions in cost-of-living adjustments. As a result, real wage levels probably will continue to rise.

We believe that rising real wages will make it virtually impossible for the government to trim the annual inflation rate below 10 percent, a primary goal of Bank of Israel Governor Michael Bruno. In our judgment, single-digit inflation can only come about

**Figure 2**  
**Israel: Private Consumption**  
**Expenditures, 1984-87**



<sup>a</sup> Percentage change over previous quarter's figure; consumption measured in constant 1980 shekels for seasonally adjusted data.

through the development of a new package deal in which Histadrut agrees to hold market or nominal wages constant for at least one year. Prospects for breaking Israel's longstanding automatic wage adjustment mechanism to lower inflation, however, appear extremely slim.

Histadrut Secretary General Israel Kessar acknowledges the need for further reform, but he is coming under growing pressure for more aggressive protection of worker interests, according to Embassy reporting. In our judgment, Kessar will adopt a tougher bargaining stance with the government to compensate for the substantial sacrifices made by labor since mid-1985.

Polls show public support for austerity has slipped. If so, the government will have a tough time rallying support for further reform efforts. In our view, Prime

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Figure 3  
Israel: Unemployment Rate, 1984-87



<sup>a</sup> Expressed as a percentage of the civilian labor force.

Figure 4  
Israel: Public Support for Economic Stabilization Efforts, 1985-87



Note: Opinion poll results start in July 1985.

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Minister Yitzhak Shamir will have to walk a narrow line in the second half of his term to maintain the budget deficit at current levels while minimizing increases in unemployment and avoiding further military spending cuts. Shamir, Finance Minister Moshe Nissim, Foreign Minister Shimon Peres, and Defense Minister Yitzhak Rabin agree that military spending was cut sufficiently during the past two years, according to Embassy reporting.

Wrangling within Likud probably will further tie Shamir's hands, according to US Embassy reporting. Deputy Prime Minister and Minister for Construction and Housing David Levi—a major contender to succeed Shamir—has consistently criticized the Economic Stabilization Program, claiming that it has hurt workers disproportionately, according to the US Embassy in Tel Aviv. Levi's populist image appeals to Israeli workers, an image that he undoubtedly will try to exploit in his maneuvering within the party.

As a result of these factors, we already see pay increases overcompensating for earlier declines, with real wages likely to rise about 5 percent in 1987 and 1988. Money supply growth of about 22 percent in 1987 and 21 percent the following year will continue to influence inflation rate developments. With dramatically higher domestic inflation than the prevailing inflation rates of its main trading partners—the United States and the European Community (EC)—the government probably will resort to further shekel devaluations akin to the 10-percent devaluation imposed in January 1987 to preserve the shekel's real exchange rate. Israel cannot count on a repeat of the positive external developments it enjoyed last year. Imported oil prices are on the rise, the US dollar is no longer appreciating, and US supplemental economic assistance has ended.

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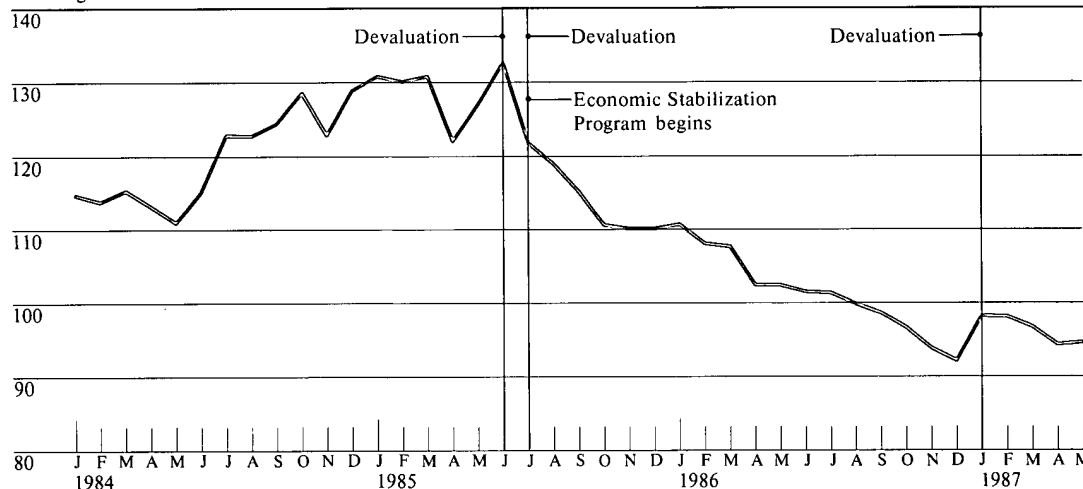
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**Figure 5**  
**Real Shekel Versus Dollar Exchange Rate, 1984-87**

Exchange rate index: December 1982 = 100



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### Baseline Forecast

On the basis of these developments and using our econometric model of the Israeli economy, we have developed a baseline forecast that projects that real gross national product growth will be at 1.2 percent in 1987 and 1.4 percent the following year. Given the wide swings in investment and capital formation—both crucial in formulating GNP—during 1983-86, however, our model may be underestimating GNP growth by 1 to 2 percentage points. Real government consumption expenditure growth will decrease by 1.1 percent in 1987 and increase by only 0.8 percent the following year. Although increasing by only 1.1 percent in 1987, we forecast real exports will rebound and increase by 4.6 percent in 1988. Our econometric model points to strong growth in total real investment during 1987 and 1988. Furthermore, the inflation rate probably will remain relatively low—between 20 and 30 percent for 1987 and 1988. Although impressively low compared with previous rates, the forecasted inflation rates still far exceed those prevailing in the United States and the EC.

The near-term outlook is not uniformly bright. The once impressive payments surplus deteriorated to a \$339 million deficit during the first three months of 1987, according to Israel's Central Bureau of Statistics. By the end of the year, the current account probably will record a deficit of about \$144 million and a deficit of \$660 million in 1988. The reversal in the current account may be partly explained by our forecasted 9.9-percent increase in real imports for 1987. In addition, we expect real private consumption to remain robust as expenditures increase by 9.7 percent in 1987 and 7.6 percent in 1988.

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Developments on several fronts could cause the Israeli economy to backslide from this scenario over the next year. The budget deficit—under control in 1985 and 1986—could swell if bailouts for troubled economic enterprises such as the kibbutzim and moshavim are

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**Table 3**  
**Israel: Economic**  
**Indicators, 1985-89<sup>a</sup>**

<sup>a</sup> Percentage change  
 from previous year  
 (except where noted)

|   | 1985   | 1986   | 1987   | 1988   | 1989   |
|---|--------|--------|--------|--------|--------|
| Real GNP                                      | 4.6    | 0.8    | 1.2    | 1.4    | -1.9   |
| Current account<br>balance<br>(million US \$) |        |        |        |        |        |
| CIA   | 1,097  | 1,371  | -144   | -660   | -899   |
| DRI   | 1,097  | 1,371  | -16    | -110   | -170   |
| Financial gap <sup>b</sup><br>(million US \$) | -3,777 | -4,280 | -4,201 | -4,463 | -5,159 |
| Real government<br>consumption                | 3.8    | 1.4    | -1.1   | 0.8    | -0.4   |
| Real private<br>consumption                   | -2.5   | 15.3   | 9.7    | 7.6    | 6.5    |
| Exports                                       | 7.3    | -1.4   | 1.1    | 4.6    | 2.8    |
| Imports                                       | -2.9   | 11.4   | 9.9    | 4.2    | 1.6    |
| Total real investment                         | -9.3   | 1.9    | 5.8    | 3.7    | 1.9    |
| Total real disposable<br>income               | -8.2   | 14.1   | 0.8    | 2.5    | 1.1    |

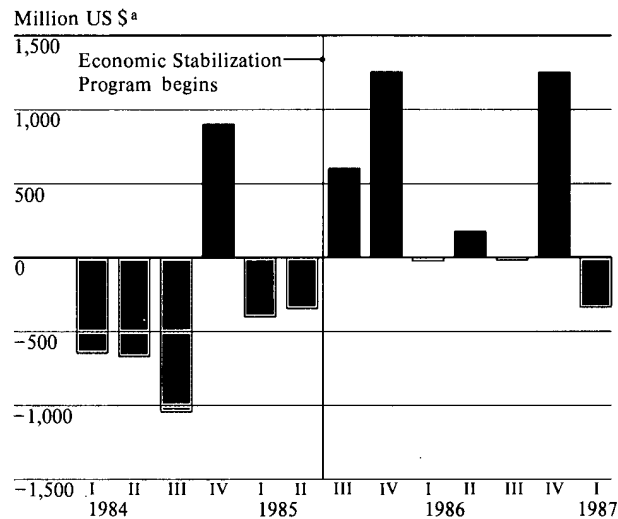
<sup>a</sup> CIA model projections. 1985 and 1986 are from historical data.

<sup>b</sup> The financial gap is the sum of the civilian goods and services deficit, self-financed military payments, and debt repayment.

adopted. The bailouts may save these enterprises, but they could lead to pressure on the government to undertake additional bailouts, further increasing the deficit. [ ]

Another threat to economic austerity is the government's bank share redemption totaling \$3.7 billion scheduled for October 1988, which follows on the heels of the smaller payment of about \$1.2 billion in October 1987. The government is committed to the redemption as a result of the collapse of the Israeli stock market in October 1983. Ministry of Finance officials fear that a large share of the repayment—all of the October 1987 payment and \$1 billion of the 1988 payment—will be spent in a binge that might destabilize the economy and rekindle the inflationary spiral. Government estimates point to households using at least 25 percent—about \$300 million of the 1987 payment—for immediate consumption. [ ]

**Figure 6**  
**Israel: Quarterly Current Account**  
**Balances, 1984-87**



<sup>a</sup> Expressed in current dollars using Bank of Israel data.

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The approach of a Knesset election in November 1988—assuming an election is not held earlier—further clouds the outlook for reform. As the election draws near, we believe that Prime Minister Shamir will be tempted to resort to expansionary fiscal or monetary policies, thereby enhancing Likud's election prospects. Resorting to expansionary economic policies probably would end Labor-Likud cooperation on economic policy formulation—an approach that already is in a precarious state. Engaging in pump-priming economics would probably scuttle serious reform efforts, greatly damaging the economy's long-term growth prospects. Labor and Likud are unlikely to support major reform initiatives before the scheduled national election for fear of a voter backlash.

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### Challenges to Further Economic Growth

Although the stabilization portion of the economic adjustment program has progressed reasonably well, there are serious problems in the second phase, which aims to bring about sustained economic growth. The relatively favorable baseline forecast for the near term begins to deteriorate significantly in 1989, by which time our model indicates that real gross national product growth will turn negative, export growth will decline, and the current account deficit and Israel's financial gap will increase. To reverse what appears to be a downward trend in the economy's performance going into the 1990s, we believe that Israel will need to overhaul its tax system while reducing the government's dominance of the capital market to lay the foundations for long-term growth and to compete more effectively in world markets. [ ]

### Tax Reform

With over half of the gross national product being collected through a variety of taxes, Israel's tax system continues to impose high costs on the national economy. In our view, high marginal income tax rates have distorted work incentives and dampened labor productivity. Moreover, the government spends a disproportionate amount of money to collect and then to transfer payments back to individuals. [ ]

The tax system's burden—as measured by the ratio of tax revenue to gross national product—has increased from 40.6 percent of gross national product in 1984 to 52.7 percent in 1986, according to the Bank of Israel. Tax revenues swelled to 54.2 percent in the first quarter of 1987. To reduce the tax system's burden and restore work incentives, the government probably will undertake some tax rate reductions in 1989 and broaden the tax base by eliminating a wide array of popular exemptions. [ ]

Projections based on the CIA's econometric model make clear that tax reform would greatly benefit the Israeli economy. If average tax rates are lowered in 1988 and 1989 about 15 to 20 percent, the model indicates that total real disposable income would soar in the first year from 0.7-percent growth to 9.4-percent growth, spurring an increase in real private consumption. In 1989 real disposable income would increase by 1.1 percent. [ ]

**Table 4**

**Israel: Impact of Lower Tax Rates, 1988-89 <sup>a</sup>**

|                                       | Baseline<br>1987 | Lower Tax Rates |       |
|---------------------------------------|------------------|-----------------|-------|
|                                       |                  | 1988            | 1989  |
| Real private consumption              | 10.3             | 10.2            | 8.1   |
| Exports                               | 1.2              | 5.0             | 3.1   |
| Imports                               | 10.2             | 6.7             | 3.1   |
| Total real investment                 | 4.2              | 0.5             | 2.1   |
| Total real disposable income          | 0.7              | 9.4             | 1.1   |
| Total direct tax revenue <sup>b</sup> | 0.7              | -13.1           | -13.1 |

<sup>a</sup> Percentage change from previous year unless noted.

<sup>b</sup> Percentage change compared to baseline 1987 and 1988 figures.

On the downside, the model shows that real import growth surges while export growth would improve only marginally. In addition, total real investment growth remains essentially flat in 1988 by increasing only 0.5 percent—perhaps in response to taxpayer uncertainty with regard to the Israeli Government's future tax policies. Total tax revenues would fall by 13.1 percent in both 1988 and 1989, leading to a surge in the budget deficit. By broadening the tax base and eliminating numerous exemptions, this budget deficit increase could be avoided. [ ]

### Capital Market Reforms

The objective of capital market reform is to reduce the government's dominant role to the minimum necessary for financing the budget or covering new debt issued by the government. To be effective, we believe capital market reforms would have to incorporate the major recommendations of the Bejski

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Commission of Inquiry—which was formed to investigate the role of commercial banks in the stock market collapse of late 1983:

- The government should compete with the private sector for funds with interest rates set by the market.
- Reserve requirements for a variety of savings schemes must be lowered to discourage government tampering in the capital market.
- Investments should be financed by specialized or commercial banks in place of the government.
- The government should phase out its requirement that certain institutions, such as insurance and pension funds, hold a fixed percentage of their funds in government bonds. [ ]

In our view, capital market reform, if fully adopted, would benefit the Israeli economy in several ways. Resource allocation would improve as funds flow according to market needs rather than government desires. Investment spending—long mired in a slump—would rebound as more funds are made available in the market. A more efficient capital market also would lure additional investment from foreign firms, which until now have been unimpressed with and uncertain about Israeli investment opportunities, according to press reports and US Embassy reporting. [ ]

#### **Constraints to Long-Term Structural Reform**

Israeli leaders clearly face policy dilemmas in implementing additional economic reforms. To place the economy on the long-term growth track, we believe that the government must continue to hold the line on real wages, maintain a fairly stable exchange rate, and trim the budget deficit to keep the lid on inflation. To maintain these conditions, the government would most likely violate one, and probably both, of the guiding principles generally observed for the past two decades:

- High unemployment—anything above 6 to 7 percent—cannot be tolerated for long because it leads many Israelis to leave Israel.
- Living standards should not be eroded. [ ]

On the basis of their public statements, we believe a consensus exists among Prime Minister Shamir, Foreign Minister Peres, and Finance Minister Nissim only on the broad outlines of economic policy as

contained in the Economic Stabilization Program. This consensus begins to fall apart when discussions get down to the details and setting of priorities, such as whose budget should be cut, by how much, which segments of Israeli society are better able to shoulder the burden, and how the poor and disadvantaged are to be protected—a key Histadrut concern. [ ]

Given these constraints, we believe that the government will be hard pressed to implement more than partial tax and capital market reforms. The first broad attempt at tax reform in March 1987 was vehemently attacked by Histadrut, which claimed that the overhaul was poorly planned and would disproportionately hurt lower income individuals. Led by Histadrut's opposition to the elimination of popular tax exemptions—such as education allowances—only a minor reform was adopted that reduced marginal income tax rates at upper income levels and lowered corporate tax rates. Given the bad climate for tax reform, the government probably will not press ahead with major new initiatives. In our judgment, the government will review the recommendations of the tax reform committee established by Finance Minister Nissim in June 1987 throughout next year but will not take action until after the Knesset election in November 1988. [ ]

In view of the instability in the capital market, we believe Tel Aviv will carry out these reforms only gradually. Existing arrangements protecting the real value of long-term assets and liabilities will probably be retained. As part of a gradual reform, we expect the government will move slowly to deemphasize its role, introducing shorter term assets that do not require protection of their real values from the ravages of inflation. [ ]

#### **The Impact of External Economic Developments**

With Israel's economy highly dependent on foreign trade and aid, unforeseen shocks—particularly changes in imported oil prices and US economic assistance—can have a devastating impact even if Israel maintains an austerity program and moves ahead with structural reforms. The first OPEC oil

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**Table 5**  
**Israel: Impact of Oil Price Shocks, 1988-89**

*Percentage change from previous year  
(except where noted)*

|  | Dramatic Shock |        | Less Dramatic Shock |        | Gradual Increase |        |
|--|----------------|--------|---------------------|--------|------------------|--------|
|  | 1988           | 1989   | 1988                | 1989   | 1988             | 1989   |
| Current account balance<br>(million US \$) |                |        |                     |        |                  |        |
| CIA  | -1,530         | -1,387 | -1,057              | -1,533 | -792             | -1,242 |
| DRI  | -762           | -888   | -419                | -828   | -223             | -517   |
| Real private consumption                   | 7.3            | 6.3    | 7.6                 | 6.2    | 7.8              | 6.3    |
| Exports                                    | 4.3            | 3.4    | 4.4                 | 3.1    | 4.5              | 2.8    |
| Imports                                    | 9.3            | -0.9   | 6.5                 | 2.6    | 5.0              | 2.6    |
| Total real disposable income               | 0.6            | 2.0    | 1.7                 | 0.8    | 2.2              | 0.7    |
| Total real investment                      | 3.7            | 1.5    | 3.7                 | 1.7    | 3.7              | 1.8    |

price shock of 1973, for example, saw Israel's oil import bill rise 200 percent to \$584 million by 1974—in the process, igniting inflation. The second OPEC oil shock of 1979-80 saw the oil import bill soar to \$1.8 billion in 1980 from about \$1.2 billion the previous year, a 50-percent increase. [ ]

#### Oil Price Shocks

Using both the CIA and Data Resources Incorporated econometric models, we simulated three scenarios incorporating changes in oil import prices.<sup>2</sup> Both models generally agreed on the outcome of the following scenarios. The first scenario assumes a dramatic increase in oil prices from the baseline forecasts of \$18 and \$19 per barrel in 1988 and 1989 to \$31 and \$32 per barrel, respectively. The second scenario assumes a less dramatic shock, with prices increasing to \$24 and \$31 in 1988 and 1989, while the third scenario incorporates a gradual change to \$20 and \$25 in 1988 and 1989. [ ]

<sup>2</sup> DRI's model of the Israeli economy was used for comparison purposes with our econometric model. Extensive use of the DRI model was not feasible, however, given its limited coverage of detailed macroeconomic variables and their relationships. [ ]

Under the *first scenario* anticipating dramatic increases in imported oil prices, the Israeli economy's performance would turn markedly downward. The current account—forecasted to record a deficit of \$660 million for 1988—would sink deeply into the red with a \$1.5 billion deficit. The deficit would drop slightly to \$1.4 billion in 1989. Import growth would soar to 9.3 percent in 1988 before decreasing by 0.9 percent in 1989, while export growth would remain virtually the same. [ ]

Under our *second scenario* assuming a less dramatic shock, the current account deficit would fall to \$1.06 billion in 1988 but then increase to \$1.5 billion in 1989. Import growth would surge ahead, increasing by 6.5 percent in 1988. Export growth, however, would remain virtually the same, increasing by 4.4 percent. [ ]

Under the *third scenario* of a very gradual price increase, our analysis suggests that Israel's current account deficit would worsen slightly in 1988 to \$792

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**Table 6**  
**Israel: Impact of Changing US**  
**Economic Assistance, 1988-89**

Million US \$

|                            | Gradual Decrease <sup>a</sup> |        | Dramatic Decrease <sup>b</sup> |        | Dramatic Increase <sup>c</sup> |       |
|----------------------------|-------------------------------|--------|--------------------------------|--------|--------------------------------|-------|
|                            | 1988                          | 1989   | 1988                           | 1989   | 1988                           | 1989  |
| Current account balance    |                               |        |                                |        |                                |       |
| CIA                        | -860                          | -1,299 | -1,060                         | -1,699 | 89                             | -149  |
| DRI                        | -341                          | -623   | -547                           | -1,049 | 639                            | 624   |
| Total interest payments    | 1,720                         | 1,814  | 1,726                          | 1,840  | 1,689                          | 1,717 |
| Short-term debt            | 534                           | 561    | 534                            | 565    | 534                            | 543   |
| Medium- and long-term debt | 1,185                         | 1,253  | 1,192                          | 1,275  | 1,155                          | 1,174 |

<sup>a</sup> Normal US economic assistance is to be \$1.2 billion in 1988 and 1989. US economic assistance is reduced to \$1 billion in 1988 and to \$800 million in 1989.

<sup>b</sup> Under this scenario, assistance is reduced to \$800 million in 1988 and to \$400 million in 1989.

<sup>c</sup> Under this scenario, assistance is increased to nearly \$2 billion in both 1988 and 1989.

million, before swelling to \$1.2 billion in 1989. Import growth would increase by 5 percent in 1988, while export growth would remain approximately the same. Total real disposable income growth would remain close to the baseline forecasts by increasing 2.2 percent in 1988.

#### Changes in US Economic Assistance

Both the CIA and DRI models demonstrate that changes in US economic assistance—as set out in the three scenarios—also would have a major impact on the Israeli economy.<sup>3</sup> The first scenario assumes that assistance is reduced to \$1 billion in 1988 and to \$800 million in 1989, compared with the current annual economic assistance of \$1.2 billion. The second scenario assumes that assistance is more sharply curtailed to \$800 million in 1988 and \$400 million in 1989. The third scenario assumes economic assistance is changed in the other direction, increasing to nearly \$2 billion for both 1988 and 1989.

<sup>3</sup> In deriving the projected impacts on Israel's current account balance, our scenarios assume that the aid reductions come as a complete surprise to the government. If, however, the aid reductions were announced ahead of time, we believe the government would step up shekel devaluations to ease the impact on the current account balance.

Using the CIA model, our analysis suggests that the *first scenario* of a gradual reduction in US economic assistance would increase Israel's current account deficit to \$860 million in 1988 and to \$1.3 billion the following year. The current account deficit would worsen to \$1.1 billion and \$1.7 billion in 1988 and 1989 if assistance is sharply curtailed as assumed under the *second scenario*. Debt interest payments would increase—both for short-term and other debt—as aid is reduced. If assistance is increased as outlined in the *third scenario*, the current account would record a surplus of \$89 million in 1988 and a slight deficit of \$149 million in 1989.

#### Implications for the United States

We believe that Israel's reliance on US economic assistance will remain critical if—as is likely—economic reform measures are adopted in a piecemeal fashion. A piecemeal approach to further tax reform—such as reducing taxes while failing to reduce the number of exemptions and to broaden the tax base

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to make tax reform revenue neutral—would greatly increase the pressure on the government to severely curtail its spending. If the government failed to curtail spending—a distinct possibility given the large number of interest groups involved in setting the government budget—we believe it would find itself faced with a sizable budget deficit to finance. To help close the budget gap, Israel would probably turn to the United States for a bailout as it did in 1985 and 1986. As a result, the needed overhaul of the tax system would be left in abeyance. [ ]

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In our judgment, piecemeal adoption of economic reform when combined with unfavorable external developments, such as a rapid increase in imported oil prices, would strain the Israeli economy. In that situation, Israeli leaders would undoubtedly turn to the United States for additional aid to close anticipated financial gaps, such as burgeoning current account deficits. Unfavorable external developments also would place further economic reforms in jeopardy, as the government could not gauge accurately the full impact of the external shock and as a consequence would probably pull back from further reform efforts.

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